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SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

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FUTURE OF THE AIRLINE INDUSTRY

Mr. Chairman, Members of the Committee, my name is Richard Anderson, and I am CEO of Northwest Airlines. Mr. Chairman and Senator Hollings, thank you and the Committee for all of the support you have given this industry, particularly in the last year. Unfortunately, the financial viability of the industry continues to deteriorate and we are confronting new economic challenges. I appreciate your holding this hearing to discuss the struggles we face.

I would like to begin today by stating three general principles that I believe are a necessary starting point for any analysis of the current state of the airline industry or any discussion of possible prescriptions for curing the severe problems it currently faces:

First, a viable and convenient air transportation system is an indispensable component of a well-functioning US economy and has developed into a critical element in the quality of life enjoyed and expected by most Americans. Our air transportation system is the best in the world, as deregulation has been a tremendous success. Aviation safety has dramatically improved since 1978; the average fare has steadily decreased as more and more Americans have had access to the air transportation system at affordable prices.

Second, network airlines, with their hub and spoke systems, have viable business models and will continue to be the most efficient means to provide high frequency, convenient air transportation service domestically and internationally, to the vast majority of Americans, particularly to those located outside the major metropolitan areas.

Third, the US airline system, in general, and the network airlines in particular, are currently facing their most significant challenges since deregulation. The industry is facing permanent changes to the revenue model that has fueled the tremendous growth and success of commercial aviation in the two decades since deregulation. What is this permanent change and how has it manifested itself? Put simply, passenger and cargo revenues have declined sharply for the whole industry. Beginning in February 2001, we saw a precipitous drop in overall airline industry revenue. Then September 11th occurred and devastated the industry. We had hoped for passenger traffic and yield recovery in the second half of 2002. That recovery did not occur. (Attachment 1 illustrates the revenue shortfall). US carriers are projected to lose more than $7 billion in 2002, and could lose another $3 billion in 2003 before reapproaching profitability in 2004.

Two statistical comparisons will bring home the dramatic nature of the challenge we are confronting in the airline industry.

- Northwest in 2002 operated an airline about the same size as we did in 1996. And we will be lucky to have about the same revenues in 2002 as we had in 1996. But to run the same size airline, our costs will be over $1 billion higher in 2002 than they were in 1996.
- At Northwest, comparing August 2002 to August 2000, our actual passenger revenue declined 20%, on 9% less capacity, and 500,000 fewer enplaned passengers, an 8% decline. During the same time period, Northwest's total operating expenses declined 11%.

What are the reasons for this precipitous drop in revenues? First, is the economic recession. We at Northwest recognized early on the impact on our business of the recession and immediately took action to begin reducing our costs. But the recession turned out to be even deeper than we, or most others, thought it would be. And, perhaps more importantly, the recession has had a much larger impact on business travel than anyone could have anticipated based on past experience. Business passenger revenues for the industry are down 21% for the first 11 months of 2002 as compared with the same period in 2001 and they were down 36% as compared with the same period in 2000. As you can see from those numbers, the revenue problem is severe.

A second, and undeniably substantial, contribution to the industry's financial difficulties was the September 11 attack, which caused the entire system to be shut down and passengers to be stranded, sometimes for days. The overall effect of September 11th and its aftermath have produced an even greater dampening effect on demand for air transportation service. And here again, the impact has been disproportionately on business travel, by making the product less convenient and hence less valuable, further reducing the willingness of business travelers to pay a premium price.

Third, there has been a fundamental change in passenger buying habits. Business passengers (and their employers) have become much more price conscious – and more willing to trade inconvenience for a lower price (a phenomenon that is not unique to airlines).

These factors that have produced the current state of affairs, I would submit, have been not only dramatic and fundamental, but to a large degree, have become permanent, irreversible features of the industry landscape. Plainly stated, passengers are accustomed to paying lower fares, especially for business travel, than they were willing to pay just a few years ago. This is not to say that the economy won't recover; but we will not see again soon, if ever, the level of economic activity during the bubble years of 1999/2000, and we will certainly not see the willingness to pay significantly higher premium fares for domestic business travel. Moreover, the sustained growth of low cost carriers means that consumers will continue to have ever-increasing opportunities to make travel choices based on price. Added to this, the Internet is a powerful and ubiquitously available enabler of individual consumer choice. It thus will continue to be a mechanism for driving the widespread availability of low fares.

How should airlines address these challenges? On behalf of Northwest, here is what we are doing. First, one thing has not changed in the way we conduct our business. Our first priority has been, and will continue to be, the provision of a safe, reliable transportation system that provides convenient service to our customers. While we have not departed from our fundamental business mission, we recognize that because we have a cost structure that is higher than our revenue generating capability, we must match our costs to the revenue generating capacity of our network.

Northwest is often identified as being in relatively better financial condition than many of the other major carriers. One reason for this is that we recognized the need, and had the will, to take early action to cut costs as the drop-off in demand began to materialize in 2001. Beginning early that year, we implemented two rounds of cost cutting before September 11th. And we've implemented additional rounds of cuts since then.

During 2001 and 2002, Northwest substantially cut flying, and with that the staffing levels and fuel expenses that went with those flights. Those flying-related cost reductions total $1.2 billion per year. More importantly, we've implemented an additional $1.2 billion per year in permanent cost reductions in 5 rounds of actions, before, during, and after September 2001. We've cut distribution costs. We've cut management headcount by 24% (1,350 positions). We have also eliminated 24% of our contract employee workforce – that's 11,980 positions eliminated. We've eliminated some major facilities entirely. We've accelerated the use of technology.

Throughout this crisis, we have met regularly with the leaders of our employees. We have three union representatives on our board and our employee leaders have been kept fully up to speed on Northwest's financial outlook and the challenges we face together. Frankly, we, as with most other US carriers, have collective bargaining agreements whose foundations were built in the era of regulation and which were negotiated in the context of a business model that is dated.

While each airline must be responsible for solving its own problems, actions by the federal government have sometimes added to, and complicated, this task.

First, we fully support and commend the Congress and DOT for the work on security. But, much of the burden and costs of implementing security safeguards mandated by the federal government has been placed on the industry. Airline tickets already bear a September 11th security fee. To that is being added extra charges in the form of un-funded mandates on airports and airlines, requiring them to bear the costs of various federal security functions: the provision of TSA office space at airports; security at airport perimeters; additional local law enforcement officers at airports to meet new TSA requirements; airport screening of caterers and other service employees; the funding of much of the build-out of airports needed to deal with new TSA requirements; and the payment of the costs of the permanent cockpit door modifications, much of which remain un-reimbursed. Congress rightly made all of these functions federal responsibilities in the Aviation and Transportation Security Act. And they ought to be funded accordingly. Second, we have had to bear the loss of revenue from prohibitions on carrying significant amounts of mail and cargo.

Third, consistent with Congress' intent in deregulating the industry, the government should allow carriers to innovate and compete to the same degree as firms in other unregulated industries. One of the major initiatives we have taken in aid of our recovery is to propose expansion of our existing, and highly successful, code sharing alliance with Continental to include Delta Air Lines. Northwest, Continental, and Delta last August submitted the proposed marketing agreement to DOT. It involves the same features as our current alliance with Continental and as the United/US Airways agreement that DOT cleared after a brief review. Like these other alliances, our marketing agreement preserves the competitive independence of the carriers, as well as their incentives to compete. There is no antitrust immunity being requested, so the carriers remain fully subject to the antitrust laws. Like the other two alliances, the marketing agreement promises substantial consumer benefits in terms of broader network offerings, new online routes, improved service on existing routes and expanded frequent flyer and lounge program benefits. These service enhancements will stimulate consumer demand and thereby allow each of the carriers to earn critical incremental revenues.

The Justice Department completed its review of the marketing agreement last October, based on our agreement to conditions that we understand to be identical to those required of United/US Airways. Nearly three months later (and more than five months since we submitted the agreement), the Department of Transportation remains enmeshed in its review of a proposal that does not present any issues that were not equally presented by the United/US Airways agreement, which DOT cleared after a review period of a little over two months. We are not asking for special treatment; only that the federal government provide equitable treatment, particularly in view of the extreme importance of the marketing agreement as part of our recovery plan.

Fourth, the airline industry is overtaxed. In 1972, shortly after the Aviation Trust Fund was established to support airport and airway development and ticket taxes were imposed, 7% of an average ticket went to ticket taxes and fees. By 1992 that figure had increased to 10.5%. Today the taxes amount to 26% of the average ticket, counting ticket taxes, security fees, and PFC's authorized by the federal government. (Attachment 2 illustrates the tax burden on a typical ticket). In the case of the most deeply discounted tickets, over 40% of the ticket price can be accounted for by government-imposed ticket taxes.

These taxes and fees are simply too high and they cannot be passed on to passengers in the form of higher ticket prices. This means that they are an added cost at a time when we are already under tremendous pressure to cut costs throughout our system.

Fifth, despite steps we have taken, distribution costs remain one of our highest cost categories. In particular, US airlines pay over $2 billion per year in Computer Reservation System fees, fees that the Departments of Justice and Transportation have long found to be excessive. We are not asking for any extraordinary relief here, only the chance to bargain for better fees, just as we bargain over the price of any other goods or services we buy. The Department of Transportation has recently proposed changes to the CRS rules that would create the possibility that we could bargain with the CRSs for more reasonable fees. This is a modest but necessary step in our ability to get these excessive costs under control, and I commend the Department for their proposal. It would in fact be one of the few ways we could reduce costs without either reducing amounts paid to employees or air service to communities.

Sixth, the overhang of war in the Middle East and its impact on fuel prices and demand is one of the biggest risks facing the airline industry right now. A war with Iraq would raise fuel costs, lead to a drop in passenger traffic and increase security measures at airports and airlines as further security precautions become necessary. In addition, carriers would have to bear an extra cost for rerouting their flights around air space in the Middle East. War would delay any recovery in the industry that is still under severe strain from the effects of the terrorist attacks of September 11^{th}.

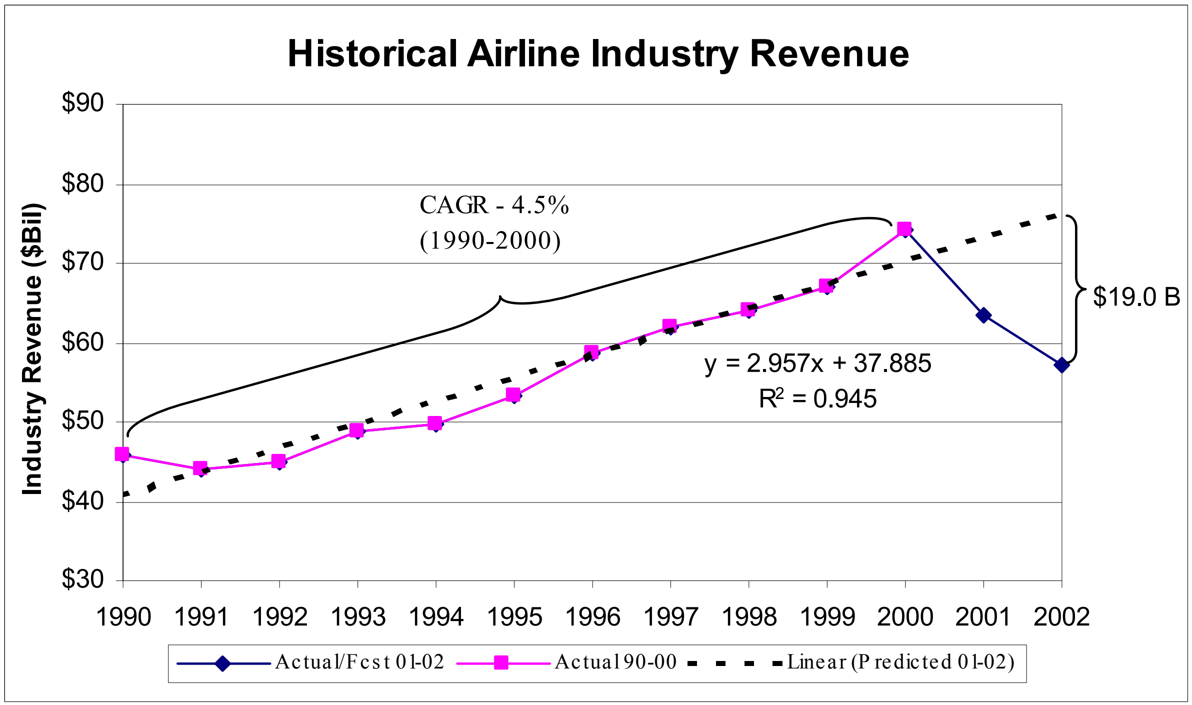
I want to thank the Committee again for its interest in these issues of critical importance not only to the industry, but also to the traveling public. Notwithstanding the huge challenges we face, I am optimistic that we will find a way to navigate through this storm. The airline industry is an indispensable component of our national economy. With responsible action by the federal government, airlines and their employees will rightly be held responsible for their own successes or their failures. We at Northwest intend to succeed. I would be happy to take any questions the Committee may have.

Attachment 1

Industry Revenue Trends

Domestic Industry Revenue Trends

- Although Industry passenger revenues have grown on average 4.5% annually from 1990-2000, revenues have significantly deteriorated since 2000
  - In fact, year 2000 should be considered as a “bubble” year with a growth rate of 10.5% vs. 1999
- Industry revenues in 2002 have deteriorated an estimated $19 billion or 25% when compared to 2002 projected revenues based on 1990-2000 actual regression



Data Source:
Form 41 (1990-Q2 2002); Actual Air Transport Association data adjusted for non-ATA carriers (Q3 2002); Estimate based on historical Q3-Q4 relationship (Q4 2002)

Attachment 2

Airline Pricing Realities and Challenges

Tax increases rob the industry of the opportunity to increase revenues

- Taxes/Fees now add 26% to the price of a connect itinerary, a 145% increase over 10 years
- Average $240 Roundtrip Ticket (YTD Nov 02 ATA Industry Average)

≈$37 increase per ticket

Airline Paid

1992 — $25.38 — 10.5%

Excise Tax	$24.00	10%
Fuel Tax	$1.38	.5%

2002 — $62.21 — 26.0%

Pending Excess Security Cost Fee	$?	
Security Fee	$10.00	4.2%
Segment Fee	$12.00	5.0%
PFC's	$18.00	7.5%
Excise Tax	$18.00	7.5%
Fuel Tax	$4.21	1.8%

NORTHWEST AIRLINES KLM Royal Dutch Airlines